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# South Cherry Street, LLC v. Hennessee Group LLC: Investors' Desperate Plea for Second Circuit Standards

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## ***South Cherry Street, LLC v. Hennessee Group LLC:*** **Investors' Desperate Plea for Second Circuit** **Standards**

IN *SOUTH CHERRY STREET, LLC v. HENNESSEE GROUP LLC*,<sup>1</sup> the United States Court of Appeals for the Second Circuit considered whether South Cherry Street, an investment fund, could bring a securities fraud claim against its investment adviser, Hennessee Group, for recommending that the fund invest in a Ponzi scheme.<sup>2</sup> The Second Circuit dismissed South Cherry Street's securities fraud claim because South Cherry Street failed to plead sufficient facts to meet the scienter requirement.<sup>3</sup> The Court erred in finding that South Cherry Street did not meet the scienter requirements promulgated under Rule 10b-5 or the Second Circuit because Hennessee Group's failure of duty to monitor established scienter.<sup>4</sup> Despite the Court's failure to find scienter, the Second Circuit Court of Appeals enunciated the right standard, which should be followed by other circuits because it strikes the appropriate balance between deterring fraud and preventing illegitimate claims.<sup>5</sup>

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1. 573 F.3d 98 (2d Cir. 2009).

2. *Id.* at 99–100.

3. *See id.* at 104, 114 (holding that the Second Circuit Court of Appeals saw no error in the rulings of the district court, and dismissing South Cherry Street's claims).

4. *See infra* Part V.A.,B.

5. *Id.*; *See infra* Part V.

## II. THE CASE

### *A. Factual Background*

In 2001, investment advisers, Hennessee Group LLC (“Hennessee”), gave a presentation to inexperienced hedge fund investors, South Cherry Street, LLC (“South Cherry”), describing its process for evaluating and recommending hedge funds.<sup>6</sup> In its presentation, Hennessee discussed its due diligence<sup>7</sup> process before recommending a fund, and its on-going due diligence after recommending a fund to an investor.<sup>8</sup> South Cherry and Hennessee entered into an oral agreement<sup>9</sup> whereby Hennessee would recommend suitable hedge fund investments to South Cherry that passed Hennessee’s due diligence evaluation.<sup>10</sup> Hennessee also agreed to provide ongoing due diligence on funds that it recommended to South Cherry.<sup>11</sup> In exchange, South Cherry agreed to pay Hennessee an annual commission of 1% of each investment made as a result of Hennessee’s recommendation.<sup>12</sup> Hennessee suggested that South Cherry invest in a hedge fund named Bayou Accredited (“Bayou”).<sup>13</sup>

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6. *S. Cherry St.*, 573 F.3d at 100.

7. Hennessee’s

[D]ue diligence process with respect to such funds included the following five levels of scrutiny prior to its recommendation of such a fund for investment: (1) collection of information about the fund’s manager; (2) assessment of the fund’s ‘Experience,’ ‘Credibility,’ and ‘Transparency’; (3) interviews of hedge fund ‘[p]ersonnel from the top down’ at the fund’s offices to give HG a sense of ‘overall professionalism, attitude and depth of organization’; (4) study of the fund’s ‘[i]ndividual positions,’ with an emphasis on its long, short, cash, and derivative positions, as well as any ‘[o]ff balance sheet transactions’; and (5) review of ‘audited financial statements,’ checks of the fund’s key personnel’s references, confirmation of the fund’s prime banking relationship, and measures to ‘Verify Auditor.’

*Id.*

8. *Id.* at 100–01.

9. *Id.* at 101. The Second Circuit Court of Appeals found that this agreement was not a legally enforceable contract pursuant to the New York Statute of Frauds because it could not be performed within one year. *Id.* at 108.

10. *Id.* at 101. The Second Circuit Court of Appeals found that this agreement was not a legally enforceable contract pursuant to the New York Statute of Frauds because it could not be performed within one year. *Id.* at 108.

11. *Id.* at 101.

12. *Id.*

13. *Id.* at 100.

Hennessee represented to South Cherry that Bayou's "legendary" trader, Samuel Israel III, had been a principal at another large hedge fund, Omega Investments.<sup>14</sup> Hennessee also told South Cherry that Bayou was independently audited by Hert Herson & Co.<sup>15</sup> South Cherry invested \$1.15 million in Bayou between the spring of 2003 and the spring of 2005 based on the recommendation of Hennessee.<sup>16</sup> Hennessee sent South Cherry monthly reports as to the status of their investment in Bayou, the last of which stated that South Cherry's investment had appreciated from \$ 1.15 million to about \$ 1.5 million.<sup>17</sup>

In September 2005, the U.S. Securities and Exchange Commission ("SEC") reported that Bayou was part of a Ponzi scheme.<sup>18</sup> Bayou had lost millions of dollars and had lied to investors about "the [f]und's performance and the value of investors' accounts."<sup>19</sup> South Cherry lost its \$1.15 million investment in Bayou.<sup>20</sup> All of Hennessee's representations to South Cherry about the Bayou Fund were false.<sup>21</sup> Samuel Israel III was not a head trader at Omega Investments.<sup>22</sup> Hert Herson & Co. had not been Bayou's auditor since 1998, and the new auditor was not independent because Bayou's principals owned the auditor.<sup>23</sup> Bayou had consistently lost money during the period that South Cherry invested in the Fund.<sup>24</sup>

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14. *Id.* at 101.

15. *Id.* at 102–03.

16. *Id.* at 101–02.

17. *Id.* at 102.

18. *Id.* A Ponzi scheme is when a fund promoter pays returns to existing investors from funds contributed by new investors, and the fund has little to no legitimate earnings from which it is paying returns to existing investors. *Ponzi Schemes—Frequently Asked Questions*, U.S. SEC. AND EXCH. COMM'N, <http://www.sec.gov/answers/ponzi.htm> (last visited Aug. 30, 2010). Ponzi schemes generally collapse when the fund has no new investors or many investors decide to cash out of the fund simultaneously. *Id.*

19. *S. Cherry St.*, 573 F.3d at 102.

20. *Id.*

21. *Id.*

22. *Id.* Israel has been a mere order taker at Omega Investments. *Id.*

23. *Id.* at 103. Bayou's principal, Daniel Marino, was also a principal of Richmond, Fairfield & Associates, and the firm that audited Bayou in 2003. *Id.*

24. *See id.* at 102 (stating that "[t]he SEC reported that 'Bayou Fund in fact lost millions of dollars in every single year it traded.'").

### B. Procedural History

South Cherry brought a securities fraud claim in the U.S. District Court for the Southern District of New York under § 10(b)<sup>25</sup> and Rule 10b-5 of Securities and Exchange Act of 1934<sup>26</sup> against Hennessee “for misrepresenting the financial status and performance of the Bayou funds.”<sup>27</sup> The district court dismissed the claim pursuant to Fed. R. Civ. P. 12(b) (6), finding that the investors failed to plead scienter.<sup>28</sup> The district court held that South Cherry failed to establish that Hennessee knew of the Ponzi scheme or that Hennessee intended to deceive South Cherry, and therefore did not meet the standard of conscious recklessness or fraudulent intent necessary to plead securities fraud.<sup>29</sup> The Court of Appeals for the Second Circuit affirmed the judgment of the district court, holding that South Cherry failed to meet the Private Securities Litigation Reform Act (“PSLRA”)’s heightened pleading standards.<sup>30</sup>

### III. LEGAL BACKGROUND

Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 set up the most basic legal standard for a plaintiff’s cause of action in a securities fraud claim.<sup>31</sup> Additionally, in 1976 the Supreme Court in *Ernst v. Hochfelder*<sup>32</sup> required the plaintiff to show scienter, which it defined as the intent to deceive, defraud or manipulate.<sup>33</sup> Since then, the scienter requirement has evolved differently in various circuits.<sup>34</sup> In 1995, Congress

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25. 15 U.S.C. § 78a *et seq* (2000).

26. 17 C.F.R. § 240.10b-5 (1998).

27. *S. Cherry St.*, 573 F.3d at 103.

28. *Id.*

29. *In re Bayou Hedge Fund Litig.*, 534 F. Supp. 2d 405, 417 (S.D.N.Y. 2007).

30. *S. Cherry St.*, 573 F.3d at 104.

31. *See* *Press v. Chem. Inv. Servs. Corp.*, 166 F.3d 529, 534 (2d Cir. 1999) (finding that SEC Rule 10b-5 “delineates what constitutes a manipulative or deceptive device or contrivance.”).

32. 425 U.S. 185 (1976).

33. *Id.* at 193.

34. *See In re Advanta Corp. Sec. Litig.*, 180 F.3d 525, 530 (3d Cir. 1999) (stating that numerous courts have considered the PSLRA pleading standard issue with split results); *In re Silicon Graphics Inc. Sec. Litig.*, 183 F.3d 970, 974 (9th Cir. 1999) (holding that the PSLRA imposes more heightened pleading standards than the Second Circuit’s pre-PSLRA standards); *Press v. Chemical Inv. Servs. Corp.*, 166 F.3d 529, 537–38 (2d Cir.1999)(holding that the PSLRA codified Second Circuit standards; *Williams v. WMX Techs., Inc.*, 112 F.3d 175, 178 (5th

passed the PSLRA,<sup>35</sup> the interpretation of which is still controversial among different circuits.<sup>36</sup>

*A. §10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 Give Plaintiffs a Private Cause of Action to Bring a Securities Fraud Claim*

The Securities Act of 1933 and the Securities Exchange Act of 1934 work in conjunction to regulate the disclosure of securities information to investors.<sup>37</sup> The Securities Act of 1933 seeks to provide disclosure about securities that are sold in interstate and foreign commerce.<sup>38</sup> The purpose of the Securities Exchange Act of 1934 is to regulate securities exchanges<sup>39</sup> and over-the-counter markets<sup>40</sup> on which securities are sold.<sup>41</sup> The

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Cir.1997) (holding that the PSLRA codified Second Circuit standards); *Voit v. Wonderware Corp.*, 977 F. Supp. 363, 374 (E.D.Pa.1997) (stating that the District Court for the Third Circuit believed The PSLRA imposed more stringent pleading standards than the Second Circuit approach).

35. 104 Pub. 67, 109 Stat. 737.

36. *See infra* note 70.

37. As defined by the Securities Exchange Act of 1934, a security is:

[a]ny note, stock, treasury stock, security future, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, reorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or in general, any instrument commonly known as a 'security'; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.

15 U.S.C. § 78c (2006).

38. Securities Act of 1933, ch. 38, 48 Stat. 74 (codified as amended at 15 U.S.C. §§77a–77aa (2006)).

39. A securities exchange is a financial market where securities are traded. *Glossary*, VIVENDI, <http://www.vivendi.com/vivendi/Glossary> (last visited Aug. 30, 2010).

40. A security traded in some context other than on a formal exchange is referred to as a trading in an “over-the counter” market. INVESTOPEDIA, <http://www.investopedia.com/terms/o/otc.asp> (last visited Aug. 30, 2010). “[O]ver-the-counter can be used to refer to stocks that trade via a dealer network as opposed to on a centralized exchange. It also refers to debt

Securities Exchange Act of 1934 enforces disclosure requirements for regulated securities.<sup>42</sup> Rule 10b-5, promulgated by the SEC, implements § 10(b) of the Securities Exchange Act of 1934, which allows individuals to hold corporations liable for engaging in deceptive practices by giving the SEC the ability to civilly prosecute anyone who makes an untrue statement or who omits “to state a material fact . . . in connection with the purchase or sale of any security.”<sup>43</sup> Case law proscribes a private cause of action for a plaintiff to bring a securities fraud claim under § 10(b) and Rule 10b-5.<sup>44</sup> A plaintiff may bring a private action if he can plead that: (1) a defendant made a false representation of a material fact or omitted material information; (2) the plaintiff relied on this misrepresentation; and (3) the defendant acted with scienter.<sup>45</sup>

### *1. Materiality*

A fact is material if a reasonable investor would consider it important in making an investment decision.<sup>46</sup> There must be a substantial likelihood that the misrepresented or omitted fact would have altered an investor’s decision.<sup>47</sup> A court may look outside of the complaint in order to determine

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securities and other financial instruments such as derivatives, which are traded through a dealer network.” *Id.*

41. 15 U.S.C. §78a et seq. (2006).

42. *See supra* note 40.

43. 15 U.S.C. § 78j(b) (2006); *see, e.g.*, *Novak v. Kasaks*, 216 F.3d 300, 305–06 (2d Cir. 2000)(noting how Rule 10b-5 specifies actions prohibited by the 1934 Act, such as making “any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading. . . .” Individuals have a private right of action to bring their own securities fraud cases under SEC Rule 10b-5. 17 C.F.R. § 240.10b-5 (2010). The SEC, however, also has the ability to bring civil cases against securities offenders on behalf of individuals affected by fraud. *Novak*, 216 F.3d at 305–06.

44. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 196 (1976) (holding that a private cause of action for damages exists under § 10(b) and Rule 10b-5, but only with an allegation of intent to deceive, manipulate, or defraud).

45. *See id.* at 202 (stating that Rule 10(b) requires conduct involving scienter).

46. *See Basic Inc. v. Levinson*, 485 U.S. 224, 231–32 (1988) (holding that public statements denying merger negotiations and denying any corporate developments that would account for heavy trading activity in its stock were material to investors who decided to sell their stock after the public denials).

47. *Id.* (noting how there must be a substantial likelihood that the disclosure of the omitted fact would have been considered by the reasonable investor as significantly altering the “total mix” of information made available).

the importance of information to a reasonable investor.<sup>48</sup> In determining materiality, a court weighs the probability that an event will occur and the anticipated magnitude of the event “in light of the totality of company activity.”<sup>49</sup> If the magnitude of an event would have immediate importance to investors regardless of whether or not the event ultimately takes place, the information surrounding the event is material.<sup>50</sup> This means that materiality is determined on a case by case basis.<sup>51</sup>

## 2. Reliance

A successful 10b-5 claim must show reasonable reliance on the material misrepresentation.<sup>52</sup> As set forth in *Straub v. Vaisman & Co., Inc.*,<sup>53</sup> reasonable reliance requires “a causal nexus between a misrepresentation or omission and the plaintiff’s injury” and a plaintiff must demonstrate that a reasonable person standing in his or her shoes would have relied on the misrepresentation or omission.<sup>54</sup> In testing reasonable reliance, courts may consider:

- (1) *whether a fiduciary relationship existed between the parties;*
- (2) *whether the plaintiff had the opportunity to detect the fraud;*
- (3) *the sophistication of the plaintiff;* (4) *the existence of long*

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48. See *Goldman v. Belden*, 580 F. Supp. 1373, 1378 (D.C.N.Y. 1984) (considering documents outside of the complaint to determine whether an amended complaint fairly stated a claim under Rule 10b-5 because the documents were central to the allegations of wrongdoing, had been submitted on defendant’s original motion, and had not been questioned in terms of their authenticity and accuracy).

49. *SEC v. Tex. Gulf Sulphur Co.*, 401 F. 2d 833, 849 (2d Cir. 1968).

50. See *TSC Indus., Inc. v. Northway, Inc.* 426 U.S. 438, 451 (1976) (noting that the standard “does not require proof of a substantial likelihood that disclosure of the omitted fact would have caused the reasonable investor to change his vote”). In *TSC Indus., Inc.*, Defendant omitted material facts relating to the degree of National’s control over TSC. *Id.* at 442. Defendant failed to disclose the positions in TSC held by National’s president and executive vice president, and reports filed with the SEC by National and TSC indicating that National may be deemed a “parent” of TSC. *Id.* at 451.

51. See, e.g., *SEC v. Geon Indus., Inc.*, 531 F. 2d 39, 47 (2d Cir. 1976) (explaining that each case must be approached on its own facts).

52. See *Straub v. Vaisman and Co., Inc.*, 540 F.2d 591, 597–98 (3d Cir. 1976) (stating that scrutiny of the plaintiff’s actions are in the context of materiality, reliance, and reasonableness).

53. See *Paracord Fin. v. Gen. Elec. Capital Corp.*, 96 F.3d 1151, 1159 (9th Cir. 1996).

54. *Id.*



*standing business or personal relationships; and (5) the plaintiff's access to the relevant information.*<sup>55</sup>

Additionally, in securities fraud cases, reliance is presumed based on the fraud-on-the-market theory,<sup>56</sup> which assumes that the market price relied on by investors reflects any material misrepresentations or omissions.<sup>57</sup> Therefore, plaintiffs do not need to show that they personally relied on the defendant's fraudulent statements.<sup>58</sup> Reliance may also be presumed if a 10b-5 claim is based on a failure to disclose information.<sup>59</sup> However, this presumption only applies if the failure to disclose involves an omission of fact "as opposed to affirmative misrepresentations."<sup>60</sup> A plaintiff's failure to disclose a fraudulent scheme may be regarded as an omission that creates the presumption of reliance.<sup>61</sup>

### 3. *Scienter*

Scienter is the "intent to deceive, manipulate or defraud."<sup>62</sup> This requisite state of mind implies that at the time that a defendant made an alleged misrepresentation or omission, he or she had knowledge or a reasonable

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55. See *Straub*, 540 F.2d at 598 (finding reasonable reliance when an investor invested based on the recommendation of a securities broker). The court stated that even a sophisticated investor "is not barred by a claim of reliance upon the honesty of those with whom he deals in the absence of knowledge that the trust is misplaced." *Id.* The court also stated that "knowing that [the plaintiff] had confidence in [the broker], [the broker] abused this trust to promote a transaction with which otherwise would have been received with caution." *Id.*

56. See *Basic, Inc. v. Levinson*, 485 U.S. 224, 245-46 (1988).

57. See *id.* at 224 (1988) (creating a presumption of investor reliance based on the theory that investors presumably rely on the market price, which typically reflects the misrepresentation or omission); *No. 84 Employer-Teamster Joint Council Pension Trust Fund v. Am. West Holding Corp.*, 320 F.3d 920, 934 n.12 (9th Cir. 2003) (discussing the purpose of courts' use of the "fraud on the market" theory).

58. See *Basic*, 485 U.S. at 246, 249.

59. See generally *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128 (1972).

60. *Poulos v. Caesars World, Inc.*, 379 F.3d 654, 666 (9th Cir. 2004).

61. The fact that investors signed certain clauses in transaction documents may render reliance unreasonable as a matter of law. See *AES Corp. v. Dow Chem. Co.*, 325 F.3d 174, 179 (3d Cir. 2002) (noting that the district court found clauses discharging warranties as to the accuracy or completeness of information renders reliance unreasonable).

62. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976).

suspicion of fraud.<sup>63</sup> If a defendant is charged with aiding and abetting a securities fraud solely by inaction, the plaintiff must also prove that the defendant had knowledge or should have had knowledge of fraud.<sup>64</sup> Similarly, the courts hold that a defendant's failure to monitor must be accompanied by an intent to aid in the fraud in order meet the scienter requirement.<sup>65</sup>

*B. The PSLRA Codified the Second Circuit's Pleading Standards and Imposed Additional Requirements to Heighten Pleading Standards*

In 1995, Congress passed the PSLRA<sup>66</sup> to limit frivolous securities law suits brought by individuals in response to the growing number of meritless securities fraud suits seeking to attain quick settlements.<sup>67</sup> Congress addressed the problem through heightened pleading standards,<sup>68</sup> which makes cases more likely to get dismissed for failure to meet pleading requirements, and protects corporations from high volumes of litigation any time a corporation's stock price decreased.<sup>69</sup> The PSLRA set a baseline of a "strong inference" requirement for scienter,<sup>70</sup> however, since the PSLRA did not define how to prove a "strong inference" the definition of scienter under the PSLRA has been hotly debated among different circuits.<sup>71</sup>

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63. *Id.* at 197 (stating that "[t]he words 'manipulative or deceptive' used in conjunction with 'device or contrivance' strongly suggest that § 10(b) was intended to proscribe knowing or intentional misconduct").

64. *Hochfelder v. Midwest Stock Exch.*, 503 F.2d 364, 374 (7th Cir. 1974).

65. *See Decker v. Massey-Ferguson, Ltd.*, 681 F.2d 111, 121 (2d Cir. 1982) (holding that a non-fiduciary accountant will only be liable for securities fraud if his reckless conduct approximates an actual intent to aid in the fraud being perpetuated by an audited company).

66. *See* S. REP. NO. 104-98, at 4, as reprinted in 1995 U.S.C.C.A.N. 679, 683.

67. *Id.*

68. *Id.*

69. *Id.*

70. *See* Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737, 747 (1995) (stating that the plaintiff must "state with particularity facts giving rise to a strong inference that the defendant acted with the required state of mind").

71. *Novak v. Kasaks*, 216 F.3d 300, 309 (2d Cir. 2000); *see supra* note 40.

### 1. Pleading *Scienter* Pre-PSLRA

Prior to the PSLRA, the Supreme Court in *Ernst v. Ernst*<sup>72</sup> held that in order to bring a claim under 10(b) and 10b-5, a plaintiff had to prove more than mere negligence.<sup>73</sup> The Second Circuit enabled a plaintiff to prove scienter by pleading facts that gave rise to an inference of either a defendant's fraudulent intent or recklessness.<sup>74</sup> Prior to Congress passing the PSLRA, the Second Circuit held that plaintiffs must allege facts that give rise to a strong inference of scienter.<sup>75</sup> An inference of fraudulent intent could be drawn from facts showing that the plaintiff had a motive and opportunity to commit the fraud.<sup>76</sup> This could be shown by the defendant gaining a benefit from the purported fraud.<sup>77</sup> According to Second Circuit's pre-PSLRA standards, a plaintiff could show a strong inference of scienter by alleging that defendants "benefitted in a concrete and personal way from the fraud, engaged in deliberately illegal behavior, knew facts or had access to information suggesting that their public statements were not accurate, or failed to check information that they had a duty to monitor."<sup>78</sup> For example, in *Goldman v. Belden*,<sup>79</sup> plaintiffs demonstrated defendants' fraudulent intent by showing that defendants made false statements to inflate a

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72. 425 U.S. 185 (1976).

73. *Id.* at 210 (holding that "judicially created private damages remedy under §10(b) . . . cannot be extended, consistently with the intent of Congress, to actions premised on negligent wrongdoing.").

74. *Rolf v. Blyth, Eastman Dillon & Co.*, 570 F.2d 38, 47 (2d Cir. 1978).

75. *Acito v. IMCERA Grp., Inc.*, 47 F.3d 47, 53 (2d Cir. 1995) (finding that a "strong inference" of fraudulent intent could not be deduced from the results of prior inspections because prior inspections had stated that the company was doing well. Thus defendant's statements about high prospects for the company could have been made in reliance of prior inspections.).

76. *See In re Time Warner Inc. Sec. Regulation*, 9 F.3d 259, 268–69 (2d Cir. 1993) (noting that one way that a plaintiff can plead scienter without direct knowledge of the defendant's state of mind is "to allege fact establishing a motive to commit fraud and an opportunity to do so").

77. *Shields v. Citytrust Bancorp, Inc.*, 25 F.3d 1124, 1130 (2d Cir. 1994) (stating that pre-PSLRA pleading standards describe "[m]otive [as] . . . entail[ing] concrete benefits that could be realized by one or more of the false statements and wrongful nondisclosures alleged").

78. *See id.* (stating that pre-PSLRA pleading standards describe motive as concrete benefits that could be realized by false statements or wrongful disclosures, and opportunity means the likely prospect of achieving these concrete benefits); *In Re Time Warner*, 9 F.3d at 270 (finding that motive was proven when defendants talked up the price of the company's stock in order to soften the dilution of the stock price).

79. 754 F.2d 1059 (2d Cir. 1985).

company's stock price and defendants would benefit concretely from higher stock prices because they owned company stock.<sup>80</sup>

After *Goldman*, the Second Circuit held that plaintiffs must make specific factual allegations before a court will presume that incorrect predictions about a company, such as predictions about inflation of stock price, are made with fraudulent intent.<sup>81</sup> In addition, the Second Circuit in *Stevelman v. Alias Research, Inc.*,<sup>82</sup> emphasized that in order to allege a strong inference of intent, defendants must have benefitted personally.<sup>83</sup> For example, defendants may benefit concretely by misrepresenting information in order to keep the stock price of the corporation high while selling their own shares for profit.<sup>84</sup> In *Shields v. Citytrust Bancorp, Inc.*,<sup>85</sup> the Second Circuit held that the fact that some people in a company received compensation as a result of a misrepresentation to an investor regarding a loan portfolio does not satisfy the motive and opportunity element necessary to prove scienter.<sup>86</sup> However, if management were to misrepresent loan portfolio values in order to sell their own shares before a price decrease, this direct economic benefit would satisfy the motive requirement.<sup>87</sup>

While the First and Seventh Circuits adopted the Second Circuit's reasoning of the "strong inference" requirement,<sup>88</sup> the Ninth and Sixth Circuits did not require a strong inference to satisfy the scienter requirement.<sup>89</sup> Rather, prior to the PSLRA, scienter was inferred by

80. *Id.* at 1070.

81. *Shields*, 25 F.3d at 1131.

82. 174 F. 3d 79 (2d. Cir. 1999).

83. *Id.* at 85.

84. *Id.* (discussing allegation that defendant corporation officer sold off large portions of his stockholdings during the time of misrepresentations as probative of motive and supporting a string inference of fraudulent intent).

85. 25 F.3d at 1130.

86. *Id.*

87. *Id.*

88. *Greenstone v. Cambex Corp.*, 975 F.2d 22, 25 (1st Cir. 1992) (stating that a complaint must set forth specific facts that make it reasonable to believe that a defendant knew that a statement was materially false or misleading); *DiLeo v. Ernst & Young*, 901 F.2d 624, 629 (7th Cir. 1990) (stating that a plaintiff's conclusory statements alleging defendant's actual knowledge of the materially false and misleading statements and omissions or reckless disregard for the truth were not a sufficient showing).

89. *In re GlenFed, Inc. Sec. Litig.*, 42 F.3d 1541, 1545 (9th Cir. 1994); *See Leoni v. Rogers*, 719 F. Supp. 555, 568 (E.D. Mich. 1989) (stating that securities fraud claims must state "the

pleading fraud with particularity that a fact was false or misleading.<sup>90</sup> The U.S. Court of Appeals for the Ninth Circuit concluded that “plaintiffs may aver scienter generally. . . that is, simply by saying that scienter existed.”<sup>91</sup> It was sufficient to allege that scienter existed without setting out the circumstances from which it could be inferred.<sup>92</sup> Nevertheless, in order to allege scienter it was necessary to set out circumstances indicating that a defendant made a false or misleading statement by stating what was false about a statement and why it was false.<sup>93</sup> Plaintiffs satisfied this requirement by setting forth the false statement and offering contemporaneous statements proving the inaccuracy of the statement.<sup>94</sup>

The Second Circuit held that conscious recklessness could be proven by showing that the defendant knew or should have known of the fraud.<sup>95</sup> For example, in *Rolf v. Blyth, Eastman Dillon & Co., Inc.*<sup>96</sup> the plaintiff met scienter when he presented evidence showing that the defendant had assured him that his investment securities were satisfactory despite being

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circumstances constituting fraud with particularity” and that “[m]alice, intent knowledge, and other condition of mind of a person may be averred generally”).

90. *Fecht v. Price Co.*, 70 F.3d 1078, 1082 (9th Cir. 1995) (finding that plaintiffs sufficiently pled securities fraud by alleging with particularity that the Company’s SEC reports had misrepresented the company’s losses. The court did not discuss motive and opportunity or recklessness. The plaintiffs alleged:

that prior to the April 2 announcement, the Company and three of its top-ranking officers intentionally misrepresented the financial condition of the Company, in particular its expansion program’s prospects for enhancing the Company’s earnings. The Complaint cite[d] various public statements-either prepared by the Company itself (Shareholder Reports, Form 10-Qs, Form 10-K, newspaper interviews) or prepared by securities analysts with the approval and guidance of the Company-and allege[d] that these statements created the impression that the Company was successfully expanding its retail warehouse operations when, in fact, the Company’s expansion program was failing.

*See also In re Glenfed, Inc.*, 42 F.3d at 1545–47 (finding that plaintiffs may plead scienter generally by merely requiring that the complaint state that scienter existed).

91. *In re Glenfed, Inc.*, 42 F.3d at 1546.

92. *Id.* at 1545.

93. *Id.* at 1548.

94. *Id.* at 1550 (finding that plaintiffs satisfied the scienter element by pleading that an issuer’s SEC filing stating no net losses on sales of its subsidiaries was false and by offering as proof of falsity, contemporaneous statements, made at board meetings, indicating that the environment for sale of its subsidiaries was unfavorable).

95. *See Rolf v. Blyth, Eastman Dillon & Co., Inc.*, 570 F.2d 38, 47 (2d Cir. 1978) (finding that reckless disregard of facts that defendant should have known, but for failure of duty to monitor, satisfied scienter).

96. 570 F.2d at 38.

aware that the quality of securities being purchased on behalf of his client were very low and the defendant's constant interaction with the purchaser of securities was such that he had the opportunity to inquire or check on the validity of the purchases.<sup>97</sup> The Second Circuit found that the pleading standard for scienter was met under the guise of conscious recklessness when the plaintiff alleged that his investment adviser had a duty to monitor and "the investment adviser responsible for the plaintiff's portfolio 'knew what he was doing' but never actually investigated" the funds he was recommending for investment.<sup>98</sup> In *Rolf*, an investor's broker "by virtue of repeatedly reassuring the investor of his confidence in an investor adviser who was mishandling the investor's portfolio and by virtue of his reckless disregard as to whether his assurances of confidence were true or false" participated in the investment adviser's securities fraud.<sup>99</sup>

## 2. Pleading Scienter Post PSLRA

Congress enacted the PSLRA as a reaction to an increasing number of "strike suits"<sup>100</sup> arising in circuit courts that brought undesirable social and economic costs.<sup>101</sup> The PSLRA heightened securities fraud pleading standards by requiring that plaintiffs allege a "strong inference" of scienter with "particularity of facts,"<sup>102</sup> and that the inference of scienter must be at least as compelling as any opposing inference of non fraudulent behavior.<sup>103</sup>

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97. *Id.* Plaintiffs did not plead fiduciary duty; however, the District Court stated that it was clear "that fraud and breach of fiduciary duty [were] present." *Rolf*, 424 F.Supp. at 1024. Defendant by virtue of being a broker dealer owed a fiduciary duty to plaintiff investor. *Id.* at 1036.

98. *See Rolf*, 570 F.2d at 47–48.

99. *Id.* at 44.

100. Strike suits are law suits filed with the intention of inducing quick and large settlements from corporations, which were eager to settle rather than incur the litigation costs. *See Blue ChipStamps v. Manor Drug Stores*, 421 U.S. 723, 740–42 (1975).

101. *See* S. REP. NO. 104–98, at 4 (1995).

102. *Novak v. Kasaks*, 216 F.3d 300, 307 (2nd Cir. 2000).

103. *See Tellabs, Inc. v. Makor Issues & Rights Ltd.*, 551 U.S. 308, 309 (2007) (holding that "[t]o determine whether the plaintiff has alleged facts giving rise to the requisite 'strong inference', a court must consider plausible nonculpable explanations for the defendant's conduct, as well as inferences favoring the plaintiff. The inference that the defendant acted with scienter need not be irrefutable, but it must be more than merely

*a. Particularity*

To survive a motion to dismiss a securities fraud claim, the plaintiff's claims may not be merely conclusory.<sup>104</sup> For example, in *Eurycleia Partners, Limited Partnership v. Seward Kissel*,<sup>105</sup> the New York Court of Appeals found the plaintiff's claim that a defendant law firm committed fraud was conclusory because it lacked any firm factual findings relevant to the defendant's knowledge of any fraudulent scheme.<sup>106</sup> In order to support a statement with particularity, a plaintiff must specify each statement that is misleading, the reasons it is misleading, and facts that support the belief that a statement is misleading.<sup>107</sup> In *Makor Issues & Rights, Ltd. v. Tellabs, Inc.*,<sup>108</sup> the Supreme Court found that a plaintiff would sufficiently plead that a defendant's statements were misleading by stating the facts that misled a plaintiff into investing in a defendant's business, contrasting the real factual circumstances with a defendant's representations, and giving references and sources concerning a defendant's mental state.<sup>109</sup>

*b. At Least as Compelling as Opposing Inferences*

In addition, the Supreme Court in *Tellabs v. Makor*<sup>110</sup> held that pleadings will only survive the "strong inference" requirement if a reasonable person would consider an inference of scienter at least as plausible as an inference of innocent behavior from the facts alleged.<sup>111</sup> Courts look at all the facts of a case, not just an individual allegation, in determining whether an inference of scienter is compelling.<sup>112</sup> The Court in *Tellabs* found that the absence of motive allegations and the failure to plead with particularity allegations of the company flooding its customers with unwanted products

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'reasonable' or 'permissible'—it must be cogent and compelling, thus strong in light of other explanations.").

104. *Eurycleia Partners, Ltd. P'ship v. Seward Kissel*, 12 N.Y.3d 553, 559 (2d Cir. 2009).

105. *Id.*

106. *Id.* at 558–59.

107. *See Tellabs*, 551 U.S. at 311–12.

108. *Id.* at 313.

109. *Id.* at 315–17.

110. *Id.* at 311.

111. *See supra* note 104 and accompanying text.

112. *See Tellabs*, 511 U.S. at 319–20.

were not fatal to finding scienter because all allegations must be taken collectively, and the plaintiff had sufficiently shown that defendants falsely reassured public investors so that their stock price would remain strong.<sup>113</sup> The inference of scienter need not be the most compelling interest.<sup>114</sup> It only needs to be strong enough that a reasonable person would deem it as strong as any opposing inference.<sup>115</sup> Information from anonymous sources is not deemed as plausible as information derived from known sources.<sup>116</sup> In weighing competing inferences, courts must take into account whether plaintiffs allege a scheme that has any chance of achieving its putative ends.<sup>117</sup> For example, in *In re PXRE Group, Ltd., Securities Litigation*,<sup>118</sup> the Supreme Court concluded that an inference of scienter was not as compelling as other inferences because the defendants' motivation to misstate their losses to raise money and offset deficits would be odd given the fact that they were not attempting to raise enough capital to offset their entire losses.<sup>119</sup> *Tellabs* requires that a court weigh competing inferences to assess the validity of securities fraud claims.<sup>120</sup> Nevertheless, while the Supreme Court has laid out the procedural requirements for pleading a cause of action under the "strong inference" requirement, it has yet to clearly define the term.<sup>121</sup> Therefore, the requisite state of mind necessary to plead scienter remains unclear.<sup>122</sup>

### *C. Circuit Split About the Meaning of Strong Inference of Scienter*

Although the PSLRA requires plaintiffs to plead a "strong inference" of scienter to survive a motion to dismiss, neither the PSLRA nor the Supreme Court have clearly defined the term "strong inference," resulting in a circuit

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113. *Id.* at 314, 322–23.

114. *Id.* at 310–11.

115. *Id.* at 310.

116. *Higginbotham v. Baxter Intern.*, 495 F.3d 753, 757 (7th Cir. 2007).

117. *In re GeoPharma, Inc. Sec. Litig.*, 399 F. Supp. 2d 432, 443 (S.D.N.Y. 2005) (noting that opportunity to commit fraud may not exist for an alleged scheme with no chance of success).

118. 600 F. Supp. 2d 510 (S.D.N.Y. 2009).

119. *Id.* at 533.

120. *See supra* note 102 and accompanying text.

121. *See id.*

122. *See In re Advanta Corp. Sec. Litig.*, 180 F.3d 525, 530 (3d Cir. 1999) (discussing the ambiguity of the "strong inference" standard that is set out by Congress in the PSLRA).



split.<sup>123</sup> While all circuits agree that plaintiffs must allege a strong inference of intent,<sup>124</sup> the requirements for proving a defendant's state of mind vary in different circuits.<sup>125</sup> Some circuits require proof of motive and opportunity to commit fraud or recklessness, while others require proof of deliberate recklessness.<sup>126</sup> While the Second Circuit holds that scienter can be proven by showing a defendant's motive and opportunity to commit fraud, the Ninth Circuit requires a plaintiff to prove that a defendant knew he was committing fraud.<sup>127</sup> The application of varying pleading requirements stems from circuits' differing views on whether the PSLRA codified the Second Circuit Court of Appeals scienter analysis or the PSLRA created a more rigorous standard than that used by the Second Circuit.<sup>128</sup>

### *1. The Second and Third Circuits Maintain Pre-PSLRA Understanding*

The Second and Third Circuits continue to hold that a plaintiff can establish a strong inference by pleading motive and opportunity to commit fraud or by showing recklessness.<sup>129</sup> Thus, the PSLRA did not alter the Second Circuit's pre-PSLRA interpretation of scienter requirements.<sup>130</sup>

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123. *Id.* (acknowledging the circuit split between a “majority of courts” that say the PSLRA “essentially codified the Second Circuit’s approach” and other courts that hold that the PSLRA “imposes an even more stringent pleading standard”); *Novak v. Kasaks*, 216 F.3d 300, 309 (2000) (Courts have disagreed on the proper interpretation of the new pleading requirement . . . in light of the text of the PSLRA and its legislative history.”).

124. The Supreme Court in *Tellabs* reiterated the fact that all plaintiffs alleging securities fraud must give rise to a strong inference of scienter. 551 U.S. 308, 317–18 (2007). It is also in the plain language of the PSLRA statute, as passed by Congress. Pub. L. 104–67, 109 Stat. 737.

125. See *supra* note 124 and accompanying text.

126. See *In re Advanta Corp.*, 180 F.3d at 530.

127. *Id.* *In re Silicon Graphics Inc. Sec. Litig.*, 183 F.3d 970, 988 (1999) (finding no strong inference of deliberate recklessness or knowing misrepresentation).

128. See *Novak*, 216 F.3d at 309–10 (“[Courts] have generally come to two conclusions: (1) [the PSLRA] effectively adopts the Second Circuit’s pleading standard for scienter wholesale . . . [or that] (2) [the PSLRA] strengthens the Second Circuit’s standard by rejecting the simple pleading of motive and opportunity.”).

129. See *supra* note 73 and accompanying text. The Second Circuit’s holding in *Rolf* was reaffirmed post PSLRA by *Nathal v. Siegal*, which held that plaintiff’s allegations that a defendant had access to internal documents that would have revealed fraud satisfied scienter. 592 F. Supp. 2d 452, 465 (S.D.N.Y. 2008).

130. *In re Advanta Corp.*, 180 F.3d at 534.

## 2. Other Circuits Require Pleading Intent with Particularity

In contrast, the Ninth Circuit found that Congress did not intend to codify the Second Circuit requirements in the PSLRA.<sup>131</sup> Instead, contrary to its pre-PSLRA relaxed scienter pleading standards,<sup>132</sup> the Ninth Circuit now imposes very stringent requirements to prove the defendant's state of mind.<sup>133</sup> In the Ninth Circuit, a plaintiff must plead with great particularity facts showing that a defendant acted with deliberate recklessness or conscious misconduct.<sup>134</sup> For example, in *In re Silicon Graphics*,<sup>135</sup> the plaintiff failed to plead deliberate recklessness because she did not mention the author of the reports or a description of the contents of reports upon which she based her belief of fraud.<sup>136</sup> Therefore, the court did not conclude that defendants knew they were committing fraud.<sup>137</sup> Similarly, the Eleventh Circuit requires pleadings that show a defendant's severe recklessness.<sup>138</sup> This standard also requires a plaintiff to show that defendants were aware they were engaging in fraudulent activity.<sup>139</sup> Finally, the Sixth Circuit holds that plaintiffs may plead scienter by alleging facts giving rise to a strong inference of recklessness without showing that defendants knew their acts were fraudulent; however, the bare pleading of

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131. See *In re Silicon Graphics*, 183 F.3d at 974 (holding that the Ninth Circuit interprets the PSLRA as requiring a plaintiff to plead evidence of deliberate recklessness or conscious misconduct). See *In re Advanta Corp.*, 180 F.3d at 534–35 (holding that in the Second Circuit it remains sufficient to establish motive and opportunity or recklessness).

132. The pre-PSLRA Ninth Circuit Court of Appeals held that plaintiffs could allege scienter simply by stating that scienter existed, without even setting forth the circumstances from which it could be inferred. *Fecht v. Price Co.*, 70 F.3d 1078, 1081–82 (9th Cir. 1995).

133. *Id.* (discussing the Ninth Circuit's requirement that plaintiffs plead deliberate recklessness or conscious misconduct).

134. *In re Silicon Graphics*, 183 F.3d at 976, 988 (discussing that unless great particularity and incriminating facts were pled, the PSLRA would not serve its function of preventing fishing expeditions).

135. *Id.* at 970.

136. *Id.* at 988.

137. *Id.*

138. *McDonald v. Alan Bush Brokerage Co.*, 863 F.2d 809, 814–15 (11th Cir. 1989) (concluding that although the securities at issue may not have had a reasonable basis for achieving the plaintiff's investment goals, unreasonableness or inappropriateness of invested securities does not meet a severe recklessness standard).

139. *Sturm v. Marriott Marquis Corp.*, 26 F. Supp. 2d 1358, 1370 (N.D.Ga. 1998) (finding that plaintiffs failed to allege that defendants knew the true value of hotel property when soliciting buyers, and therefore did not deliberately or recklessly misrepresent the hotel's value).

motive and opportunity alone does not constitute a strong inference of scienter.<sup>140</sup>

#### IV. THE COURT'S REASONING

In *South Cherry Street, Limited Liability Co. v. Hennessee Group Limited Liability Co.*,<sup>141</sup> the United States Court of Appeals for the Second Circuit affirmed the U.S. District Court for the Southern District of New York's dismissal of South Cherry's securities fraud claim on the basis that South Cherry failed to plead scienter.<sup>142</sup> Judge Kearse began by explaining that in order to state a claim for securities fraud, a plaintiff must plead that a defendant made a false representation as to a material fact or omitted material information and acted with scienter in connection with the purchase or sale of securities.<sup>143</sup>

The Court discussed its interpretation of the scienter requirement under the PSLRA's heightened pleading requirements.<sup>144</sup> The Court stated that the plaintiff must state particular facts that give rise to a strong inference that the defendant intended to "deceive, manipulate, or defraud" to meet the requirement of scienter under the PSLRA.<sup>145</sup> The Court reasoned that a strong inference of scienter may arise when a complaint alleges that the defendants

*(1) benefitted in a concrete way and personal way from the purported fraud . . . ; (2) engaged in deliberately illegal behavior . . . ; (3) knew facts or had access to information suggesting that their public statements were not accurate . . . ; or (4) failed to check information they had a duty to monitor.*<sup>146</sup>

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140. *In re Comshare, Inc. Sec. Litig.*, 183 F. 3d 542, 551–52 (6th Cir. 1999) (holding that the fact that defendants would benefit from an increase in stock price was relevant to show recklessness, but defendant's error in recognizing revenue was not so obvious that a reasonable man would have known they were in error).

141. 573 F.3d 98 (2d Cir. 2009).

142. *Id.* at 114.

143. *Id.* at 108.

144. *Id.*

145. *Id.*

146. *Id.* at 110 (citing *Novak v. Kasaks*, 216 F.3d 300, 307–09 (2d Cir. 2000)).

The Court determined that the defendant's failure to monitor the fund was not sufficient to establish scienter by following the precedent set in *Decker v. Massey-Ferguson*.<sup>147</sup> *Decker* held that a non-fiduciary's failure to identify a company's internal problems was not sufficient to establish scienter.<sup>148</sup> In order for a defendant's failure to monitor a company to satisfy the scienter requirement, a defendant would have to fail to monitor with the intent of aiding in fraud.<sup>149</sup> The Court found that South Cherry failed to allege that Hennessee knew that the statements it made were untrue, that Hennessee knew of the falsity of the representations it gave South Cherry, or that Hennessee should have been alerted to the falsity of the representations.<sup>150</sup> Therefore, South Cherry failed to plead scienter.<sup>151</sup>

The Court qualified a strong inference by applying a comparative analysis between the inference of scienter and any opposing inferences of non-fraudulent or non-reckless intent.<sup>152</sup> While South Cherry urged that Hennessee's failure to conduct due diligence was motivated by the fact that Hennessee wanted to receive a recommendation fee without incurring the expense of due diligence, the Court reasoned that it was at least as compelling to infer that Hennessee was simply negligent in discovering the truth about Bayou.<sup>153</sup> The Court explained that Hennessee, priding themselves on their expertise in recommending funds, was not likely to risk its reputation deliberately by conducting little inquiry on a recommended fund.<sup>154</sup>

## V. ANALYSIS

The Second Circuit Court of Appeals correctly interpreted the PSLRA's pleading standards. Nevertheless, the Court failed to correctly apply those standards when it determined that South Cherry had not met the scienter requirements imposed by Rule 10(b) and Rule 10b-5.<sup>155</sup> In light of

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147. See *id.* at 114 (holding that the allegations in the complaint did not give rise to conscious recklessness). See also *Decker v. Massey-Ferguson*, 681 F.2d 111 (2nd Cir. 1982).

148. *Decker*, 681 F.2d 111 at 119.

149. *Id.*

150. *S. Cherry St.*, 573 F.3d at 114.

151. *Id.*

152. *Id.* at 111 (citing *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308, 314 (2007)).

153. *Id.* at 113.

154. *Id.*

155. See *infra* Part V.A.

numerous recently uncovered fraudulent schemes in the financial services industry,<sup>156</sup> it is clear that the public interest is best served by affording investors greater opportunities to prosecute securities fraud claims. All circuits should uniformly adopt the Second Circuit's motive and opportunity or recklessness requirements to effectively deter frivolous securities fraud claims while empowering defrauded investors to bring legitimate claims.<sup>157</sup>

*A. Congress Intended to Uniformly Impose Heightened Pleading Standards on all Circuits by Codifying the Second Circuit's Pre-PSLRA Scienter Requirements*

Legislative history and the plain language of the PSLRA indicate Congress's intent to codify the securities fraud pleading standards developed by the Second Circuit Court of Appeals that require plaintiffs to show motive and opportunity or conscious recklessness in order to satisfy scienter.<sup>158</sup> At the time the PSLRA was passed, the Second Circuit's pleading standards were the most stringent.<sup>159</sup> Uniform federal application of these pleading standards fit Congress's purpose of significantly heightening national securities fraud pleading standards.<sup>160</sup> In addition, the PSLRA's requirement that plaintiffs plead scienter with particularity of facts tweaked the Second Circuit's standard to prevent plaintiffs from bringing generalized "motive and opportunity" claims.<sup>161</sup>

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156. See generally, *U.S. v. Stanford*, 341 Fed. App'x. 979 (5th Cir. 2009); *Sec. and Exch. Comm'n v. Bernard L. Madoff and Bernard L. Madoff Inv. Sec. LLC*, Civ. 08 CV 10791 (S.D.N.Y. 2009).

157. See *id.*

158. Richard H. Walker & J. Gordon Seymour, *Recent Judicial and Legislative Developments Affecting the Private Securities Fraud Class Action*, 40 ARIZ. L. REV. 1003, 1024–25 (1998) (discussing Congress's legislative intent to codify the Second Circuit Court of Appeals pleading standards and quoting President Clinton's veto message that the Second Circuit Court of Appeals had "the highest standard of any Federal circuit court"); see *supra* Part III. B(a).

159. 141 Cong. Rec. H15, 215 (daily ed. Dec. 20, 1995) (President Clinton, in 1995, stated that he was "prepared to support the high pleading standards of the U.S. Court of Appeals for the Second Circuit—the highest pleading standard of any Federal circuit court"); see also *supra* Part III.B.a.

160. See *In re Advanta Corp. Sec. Litg.*, 180 F.3d 525, 534 (3rd Cir. 1999) ("In many jurisdictions, adoption of a 'strong inference' standard will substantially heighten the barriers to pleading scienter, a result Congress expressly intended.").

161. *Id.* at 535.

The Senate Committee on Banking, Housing and Urban Affairs stated that the PSLRA pleading standard was “modeled upon the pleading standard of the Second Circuit.”<sup>162</sup> Legislative history indicates that the language adopted by Congress in the PSLRA is based in part on the Second Circuit’s pre-PSLRA pleading standards.<sup>163</sup> Congress also stated that it found the body of law regarding the strong inference requirement “instructive.”<sup>164</sup>

The Committee also reported that courts may find the Second Circuit’s body of law instructive.<sup>165</sup> President Clinton vetoed the PSLRA, stating that he was not prepared to require more procedural hurdles than those imposed by the Second Circuit.<sup>166</sup> Although Congress eventually overrode the President’s veto, many legislators reaffirmed the fact that the PSLRA was intended to codify the Second Circuit standard.<sup>167</sup> The SEC also filed amicus briefs to several court of appeals cases litigating the PSLRA standards.<sup>168</sup> The briefs stated that Congress intended to adopt the Second Circuit’s pleading standards.<sup>169</sup>

Finally, the plain language of the PSLRA mirrors that of the Second Circuit.<sup>170</sup> The “strong inference” of scienter language in the PSLRA is identical to the language set out in Second Circuit case law.<sup>171</sup> For example, in *Acito v. IMCERA Group Inc.*,<sup>172</sup> the Second Circuit Court of Appeals found that “plaintiffs must also allege facts that give a strong inference of scienter.”<sup>173</sup> Similarities between the PSLRA’s “strong inference” language and the pre-PSLRA Second Circuit “strong inference” pleading standard reaffirm the idea that the PSLRA was modeled after the Second Circuit’s scienter pleading requirements.<sup>174</sup> In contrast, the PSLRA’s language

162. See H.R. CONF. REP. NO. 104-369, at 41 (1995).

163. *Id.*

164. S. REP. NO. 104-98, at 15 (1995).

165. *Id.*

166. See Walker & Seymour, *supra* note 156, at 1023.

167. See *supra* note 144 and accompanying text.

168. *Id.*

169. *Id.*

170. *In re Advanta Corp. Sec. Litig.*, 180 F.3d 525, 532 (3d Cir. 1999).

171. 15 U.S.C.A. § 78u-4(b)(2) (stating that a plaintiff must state with particularity facts that give rise to “a strong inference that the defendant acted with the required state of mind”).

172. 47 F.3d 47 (2d Cir.1995).

173. *Id.* at 53.

174. See *supra* note 161.

significantly differs from the pre-PSLRA standards of the Ninth and Sixth Circuits, which did not require strong inference to satisfy scienter.<sup>175</sup>

*B. South Cherry Had a Cause of Action Under Rule 10(b) and 10b-5 Because Hennessee Made Material False Representations; South Cherry Relied on These Representations, and Hennessee Acted with Scienter When it Recommended the Bayou Fund*

*1. Hennessee's Material Misrepresentations*

Similar to *TSC Industries, Inc. v. Northway, Inc.*,<sup>176</sup> South Cherry satisfies the first prong of a 10b-5 claim because Hennessee's representations would have had immediate importance to South Cherry.<sup>177</sup> The fact that Samuel Israel III was never head trader at Omega Investments and that the fund was being audited by an audit group owned by the Bayou's principal would have been material to South Cherry's investment decisions.<sup>178</sup>

*2. South Cherry's Reliance*

Applying the Second Circuit's reliance elements as set forth in *Straub v. Vaisman and Co, Inc.*,<sup>179</sup> South Cherry would be found to have reasonably relied on Hennessee's representations.<sup>180</sup> A fiduciary relationship existed between Hennessee and South Cherry by virtue of Hennessee being an investment adviser to South Cherry.<sup>181</sup> South Cherry hired Hennessee to

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175. See *supra* note 90 and accompanying text.

176. 429 U.S. 810 (1976).

177. *Id.* at 449 (noting that a fact is material when there is a substantial likelihood that a reasonable shareholder would consider it important).

178. See *S. Cherry St., LLC v. Hennessee Grp. LLC*, 573 F.3d 98, 103 (2d Cir. 2009) (finding that Israel had been a mere clerk prior to forming the Bayou Fund).

179. 540 F.2d 591 (3d Cir. 1976).

180. *Id.* at 597-98 (3d Cir. 1976) (listing the elements to find reasonable reliance as: (1) whether a fiduciary relationship existed between the parties; (2) whether the plaintiff had the opportunity to detect the fraud; (3) the sophistication of the plaintiff; (4) the existence of long standing business or personal relationships; and (5) the plaintiff's access to the relevant information).

181. A fiduciary relationship exists between investment advisers and their investors. See *Exch. Com'n v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 191 (stating "[t]he Investment Advisers Act of 1940...reflects a congressional recognition of the delicate fiduciary nature of an investment advisory relationship") Additionally, in an administrative proceeding, the SEC found

research the validity of Bayou's investments specifically because South Cherry did not possess expertise in these types of investments; therefore, South Cherry would not have had the opportunity to detect the fraud.<sup>182</sup>

### 3. *Hennessee's Scienter*

South Cherry also satisfied the scienter requirement of 10b-5 by alleging that Hennessee knowingly made misrepresentations to South Cherry.<sup>183</sup> Some of Hennessee's misrepresentations, such as the name of the fund auditors, were easily discoverable by Hennessee,<sup>184</sup> enough so that Hennessee should have known that it was making false representations to its clients.<sup>185</sup> Therefore, as the court in *Hochfelder v. Midwest Stock Exchange*<sup>186</sup> similarly concluded, "but for a breach of duty of inquiry, [Hennessee] should have had knowledge of the fraud."<sup>187</sup> The Second Circuit's decision in *Teamsters Local v. Dynex Capital Inc.*<sup>188</sup> stated that to raise an inference of scienter from failure of duty to monitor, a plaintiff must specifically identify "reports or statements that would have come to light in a reasonable investigation and that would . . . [demonstrate] the

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that Hennessee "owed fiduciary duties to their clients." Investment Advisers Act of 1940, Release No. 2871, April 22, 2009.

182. *Id.* Also, while Hennessee is a secondary actor, investors showed reliance on the defendant's own deceptive conduct so that Hennessee could be held primarily liable. *See generally* Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc., 552 U.S. 148 (2008) (holding that in order for defendants that would normally be secondarily liable to be primarily liable, plaintiffs must allege that they relied on the defendant's own conduct). Finally, even if they had been experienced investors, the Court in *Straub* held that sophisticated investors should be able to rely upon the "honesty of those with whom he deals in the absence of knowledge that the trust is misplaced." *See supra* note 53 and accompanying text.

183. 15 U.S.C. § 78j(b) (2000).

184. *See infra* note 190.

185. *See* S. Cherry St., LLC v. Hennessee Grp. LLC, 573 F.3d 98, 102–03 (2d Cir.2009) (discussing South Cherry Street's complaint that if the Hennessee Group had performed any real due diligence, it would have easily discovered that Israel had not been head trader at Omega Investments and that Hetz Herson & Co. were no longer auditing the fund).

186. *Hochfelder v. Midwest Stock Exch.*, 503 F.2d 364 (7th Cir. 1974).

187. *Id.* at 374 (holding that because plaintiffs did not allege that defendant knew or should have known of the fraud, they did not plead a sufficient claim of securities fraud).

188. *Teamsters Local 445 Freight Div. Pension Fund v. Dynex Capital Inc.*, 531 F.3d 190 (2d Cir. 2008).



falsity of the allegedly misleading statements.”<sup>189</sup> Unlike the plaintiffs in *Teamsters Local*, South Cherry specifically alleged that had Hennessee:

*[P]erformed any real due diligence in 2004. . . it would have discovered, inter alia, that Israel, prior to forming Bayou Fund, had been a mere clerk, that HHCO [Hert Herson & Co.] had not been the auditor for any of the Bayou-related funds since 1998, and that the new auditor was not independent because it was owned by Marino, a Bayou Fund principal.*<sup>190</sup>

*4. A Finding of Scier from Failure of Duty to Monitor is Consistent with Recent Case Law*

*South Cherry Street* is similar to *Rolf v. Blyth*<sup>191</sup> and *Nathel v. Siegal*,<sup>192</sup> where the Second Circuit Court of Appeals and the Southern District of New York, respectively, held that plaintiffs met scier requirements by showing defendants’ failure to monitor.<sup>193</sup> In *Rolf*, a defendant who assumed a duty to monitor by agreeing to act as investor’s broker, reassured the plaintiff that the investment adviser was doing a good job by recommending investments without investigating the adviser’s decisions.<sup>194</sup> The Second Circuit Court of Appeals held that the defendant-broker had a duty to determine whether the statements she made to her client had any

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189. *Id.* at 196.

190. *S. Cherry St.*, 573 F.3d at 103. Additionally, in 2005 the SEC charged the Bayou Group for running a Ponzi scheme. The “red flags” that caught the attention of the SEC may indicate that Hennessee should have known that statements made by the Bayou Fund to Hennessee were obviously suspicious. Both SEC investigations and recent case law support a finding of scier from Hennessee’s failure to monitor the Bayou Fund. See Rachele Younglai, *SEC Charges Hennessee on Bayou Hedge Fund Miss*, REUTERS, (Apr. 22, 2009), <http://www.allbusiness.com/legal/banking-law-banking-finance-regulation/12409453-1.html> (discussing the SEC’s charges against Bayou for failing to properly review the hedge fund before recommending their clients to invest); See *infra* Part V.A.1–2.

191. 637 F.2d 77 (2d Cir. 1980).

192. 592 F. Supp. 2d 452, 465 (S.D.N.Y. 2008).

193. See *Rolf*, 637 F.2d at 80 (holding that a defendant’s aiding and abetting fraud satisfies scier); *Nathel*, 592 F. Supp. 2d at 465 (holding that plaintiff’s allegations that defendant had access to internal documents that would have revealed fraud satisfied scier).

194. *Rolf*, 637 F.2d at 80. While the Court in *Rolf* discussed the defendant’s fiduciary duties to investor, there is no indication that plaintiffs specifically plead fiduciary duty on appeal. *Id.*

factual basis.<sup>195</sup> Similarly, Hennessee assumed a duty to monitor when it agreed to perform due diligence and advise South Cherry on its hedge fund investments.<sup>196</sup> Without performing any of the due diligence it had agreed to, Hennessee reassured South Cherry that Bayou was performing well.<sup>197</sup> Likewise, in *Nathel v. Siegel*,<sup>198</sup> the Second Circuit denied a motion to dismiss a securities fraud claim, holding that the plaintiffs met scienter by showing that defendants, investment advisers, recommended investments and assured investors of an investment's likely profitability and tax benefits without proper investigation.<sup>199</sup> The defendants in *Nathel* represented that they were knowledgeable about the types of investments they were recommending.<sup>200</sup> The Court found that plaintiffs successfully pleaded scienter by showing a failure of duty to monitor, and therefore recklessness, because defendants had "made no investigation into the validity of investments, and thus made representations to investors 'without any basis.'"<sup>201</sup>

South Cherry successfully alleged a duty to monitor by showing that Hennessee failed to perform the most rudimentary due diligence on the Bayou Fund by failing to investigate the fund auditor's name or the biography of the fund's principals.<sup>202</sup> Consistent with cases such as *Rolf* and *Nathel*, Hennessee's failure to check information that it had a duty to monitor shows strong circumstantial evidence of recklessness.<sup>203</sup>

195. *Id.* at 47–48.

196. *S. Cherry St., LLC v. Hennessee Grp. LLC*, 573 F.3d 98, 101 (2d Cir.2009) (stating that Hennessee agreed to perform "detailed and rigorous five step due diligence process").

197. *Id.* at 102 (describing how all of the figures Hennessee Group provided to South Cherry showed profits that were in fact large losses).

198. 592 F. Supp. 2d at 465.

199. *See id.* at 459.

200. *Id.* at 463 (stating that they were "very familiar" with the investments that they recommended and that they "knew what they were doing").

201. *Id.* at 463–65.

202. *S. Cherry St.*, 573 F.3d at 103.

203. *See supra* note 146 and accompanying text. The SEC's contentions against Hennessee in this matter also support their failure of duty to monitor, although they have no bearing on the decision making of the Court. *Id.* In April 2009, the SEC charged Hennessee for failing to properly review the Bayou Group hedge fund before recommending their clients to invest. Order Instituting Administrative and Cease-and-Desist Proceedings Hennessee Group LLC, Investment Advisers Act of 1940, Release No. 2871, 2009 SEC LEXIS 1365, at \*3 (April 22, 2009). The SEC stated that Hennessee violated Section 206(2) of the Advisers Act by failing to "conduct a reasonable investigation into red flags" and by relying on financial information that Bayou handed them, rather than conducting the informed analysis that was advertised to its investor

*C. South Cherry met the Pre-PSLRA Second Circuit Scienter Requirement by Showing a “Strong Inference of Fraudulent Intent or a Reckless Disregard for the Truth”*

South Cherry’s contention that Hennessee wanted to receive a referral fee without incurring due diligence costs satisfies the scienter requirement as laid out in *Press v. Chemical Investment Services Corp.*,<sup>204</sup> where the plaintiff “barely” alleged motive, but survived a motion for summary judgment in the Second Circuit.<sup>205</sup> The Second Circuit has allowed plaintiffs to satisfy scienter based on “fairly tenuous inferences.”<sup>206</sup> In fact, the Second Circuit stated higher scienter standards would make it almost impossible for a plaintiff to plead scienter against a corporation.<sup>207</sup>

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clients *In the Matter of Hennessee Group, LLC and Charles J. Gradante*, SEC NEWS DIGEST ISSUE 2009–76, Apr. 22, 2009, available at <http://www.sec.gov/news/digest/2009/dig042209.htm>. Section 206(2) of the Investment Advisers Act of 1940 prohibits any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client. Order Instituting Administrative and Cease-and-Desist Proceedings Hennessee Group LLC, Investment Advisers Act of 1940, Release No. 2871, 2009 SEC LEXIS 1365, at \*3 (April 22, 2009). The SEC also found that Hennessee “decided not to perform any analysis after Bayou refused to produce its trading data.” *Id.* SEC enforcement investigations showed that Bayou gave contradictory responses as to who was auditing the fund, after which Hennessee failed to investigate Bayou’s responses. *Id.* The SEC investigation and findings strongly support the fact that Hennessee did not actually review Bayou’s information, even in the face of obviously “evasive” or “suspicious” statements that Hennessee relied on. *See* Sec. Exch. Comm’n v. McNulty, 137 F.3d 732, 741 (2d Cir.1998) (finding that defendant displayed reckless disregard when he disclosed statements to his client that were obviously evasive or suspicious). In addition to supporting Hennessee’s failure of duty to monitor, the SEC found that Hennessee had “willfully” violated the Adviser’s Act, supporting the South Cherry Street’s strong inference of scienter. Order Instituting Administrative and Cease-and-Desist Proceedings Hennessee Group LLC, Investment Advisers Act of 1940, Release No. 2871, 2009 SEC LEXIS 1365, at \*3 (April 22, 2009). The SEC’s charges were filed before the Second Circuit Court of Appeals, which decided the *South Cherry* in July 2009. *In the Matter of Hennessee Group, LLC and Charles J. Gradante*, SEC NEWS DIGEST ISSUE 2009–76, Apr. 22, 2009, available at <http://www.sec.gov/news/digest/2009/dig042209.htm>; *S. Cherry St.*, 573 F.3d at 98 (decided on July 14, 2009).

204. 166 F.3d 529 (2d Cir. 1999).

205. *Id.* at 538.

206. *Id.*

207. *Id.* (finding that plaintiff met barely alleged motive and opportunity by alleging that defendant wanted to use the funds and that the funds at maturity were in defendant’s control; however, the Court would allow the finder of fact to hear the case because otherwise it would be virtually impossible for a plaintiff to plead scienter against a corporation that did not involve “specifically greedy comments from an authorized corporate individual”).

*D. In Light of Limited Federal Oversight in the Financial Services Industry, the Second, Third and Fifth Circuit's Interpretation of the PSLRA Pleading Standards Best Serve the Public Interest*

The Second, Third and Fifth Circuits' application of the PSLRA as a codification of the Second Circuit Court of Appeals pleading standards encourages private litigants to bring securities fraud actions, which help regulate the financial services industry.<sup>208</sup> Private securities fraud actions are a powerful tool for securities fraud enforcement. Private actions against hedge fund advisers are particularly important because hedge funds are neither regulated nor transparent.<sup>209</sup>

For these reasons, the SEC opposed the Ninth Circuit's decision to heighten the Second Circuit's standards in *In re Silicon Graphics Inc. Securities Litigation*.<sup>210</sup> The SEC has limited resources, and cannot prosecute all securities fraud cases, as we have seen from scandals such as the Madoff Fund.<sup>211</sup> Therefore, it is essential to supplement enforcement of

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208. Walker & Seymour, *supra* note 156 at 1003.

209. See Younglai, *supra* note 186 (quoting a statement made by Antonia Chion, an associate director in the SEC's enforcement division: "The advice that clients receive from hedge fund consultants is especially critical when the hedge funds are neither regulated nor transparent."). The Dodd-Frank Wall Street Reform and Consumer Protection Act

[r]equires regulators to implement regulations for banks, their affiliates and bank holding companies, to prohibit proprietary trading, investment in and sponsorship of hedge funds and private equity funds, and to limit relationships with hedge funds and private equity funds. Nonbank financial institutions supervised by the Federal Reserve will also have restrictions on their proprietary trading and hedge fund and private equity investments.

Kristin Brost, *Summary: Restoring American Financial Stability*, SENATE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS, [http://banking.senate.gov/public/\\_files/FinancialReformSummary231510FINAL.pdf](http://banking.senate.gov/public/_files/FinancialReformSummary231510FINAL.pdf).

210. 183 F.3d 970 (9th Cir. 1999). See Herbert E. Milstein, *Some Recent Developments in the Private Securities Litigation Reform Act*, 5. NO. 21 ANDERLR 12, 1 (2000) ("The [SEC] stands unequivocally against the Ninth Circuit's decision in *Silicon Graphics*."). *Silicon Graphics* held that the PSRLRA imposes more heightened pleading standards than the Second Circuit's pre-PSLRA standards. *In re Silicon*, 183 F.3d at 974.

211. 183 F.3d 970 (9th Cir. 1999). See Herbert E. Milstein, *Some Recent Developments in the Private Securities Litigation Reform Act*, 5. NO. 21 ANDERLR 12, 1 (2000) ("The [SEC] stands unequivocally against the Ninth Circuit's decision in *Silicon Graphics*."). *Silicon Graphics* held that the PSRLRA imposes more heightened pleading standards than the Second Circuit's pre-PSLRA standards. *In re Silicon*, 183 F.3d at 974.

securities fraud by allowing private actors to bring cases as well.<sup>212</sup> Adopting higher pleading standards, such as the Ninth's Circuit's requirements in *In re Silicon*,<sup>213</sup> may incentivize securities fraud because the risk of private securities fraud cases brought against them would be lowered. "If we want to continue to prosecute securities fraud actions and give plaintiffs a more even playing field against the naturally closed, secretive nature of corporations and their officers," the Second Circuit's approach to pleading scienter furthers that purpose.<sup>214</sup> Private securities actions serve as a deterrent to fraud and provide a quick way for investors to recover losses.<sup>215</sup>

## VI. CONCLUSION

The Second Circuit sets precedent in securities fraud pleading standards, as is evidenced by the PSLRA's codification of Second Circuit standards.<sup>216</sup> The Second Circuit's finding that South Cherry failed to plead the requisite intent is inconsistent with case law.<sup>217</sup> Hennessee's failure to conduct simple due diligence in the face of the Bayou Fund's obviously suspicious statements satisfy the PSLRA scienter requirement.<sup>218</sup> Nevertheless, the Second Circuit's interpretation of the PSLRA pleading standards is accurate, and should be uniformly applied in every circuit.<sup>219</sup> More stringent interpretations of the PSLRA impose unfair procedural hurdles for plaintiffs bringing securities fraud claims, which run contrary to the purpose of the PSLRA and may spawn uninformed investors.<sup>220</sup>

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212. *Id.*

213. 183 F.3d 970, 974 (9th Cir. 1999).

214. *Id.*

215. *Id.*

216. *See supra* Part V.A.

217. *See supra* Part V.B.4.

218. *See supra* Part V.B.3.

219. *See supra* Part V.A., D.

220. *See supra* Part V.D.